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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

The Value-Added Tax in Western Europe: Some Implications for the United States

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CENTRAL INTELLIGENCE AGENCY
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INTELLIGENCE MEMORANDUM

THE VALUE-ADDED TAX IN WESTERN EUROPE: SOME IMPLICATIONS FOR THE UNITED STATES

Introduction

1. The nearly completed harmonization of major indirect tax systems in the European Community (EC) is a significant step toward reducing tax obstacles to intra-EC trade and, ultimately, eliminating tax frontiers among the member countries. The EC's adoption of the value-added tax (VAT) -- together with VAT's spread to Scandinavia, the United Kingdom, and Ireland -- has become a matter of consequence to the United States at a time when export expansion is urgent. Exports from countries relying heavily on indirect taxes may gain a competitive advantage over exports from countries such as the United States that rely heavily on direct taxes. The VAT has been adopted by France, West Germany, the Netherlands, Belgium, Luxembourg, Denmark, Norway, and Sweden. Ireland is scheduled to implement VAT in 1972; Italy and the United Kingdom, in 1973. Further indirect tax harmonization among the EC countries would entail primarily the alignment of VAT rates. This step would require major overhaul of domestic tax systems, however, and could meet strong resistance on political and social grounds.

2. This memorandum describes West European progress toward indirect tax harmonization and notes the competitive effects on US producers and exporters. The reasons for replacing cascade turnover taxes with VAT, the features of VAT systems adopted by West European countries, inflationary problems associated with implementation of VAT, and the implications of VAT for US policy are discussed in turn.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Discussion

The EC Pioneers Tax Harmonization

3. Even before the EC was established in 1958, differences in indirect tax systems greatly concerned EC countries because trade flows and international competition were impeded, while vertical integration to avoid taxes was encouraged. When the EC was formed, France was using a VAT system instituted in 1954. The early French VAT, however, covered only manufactured goods (solely at the producer level) and construction activity. Other French goods and services were subject to various other indirect taxes. West Germany, the Netherlands, and Luxembourg employed "cascade" turnover tax systems. Belgium and Italy had mixed systems, including cascade taxes as well as indirect taxes levied at a single point in the production-distribution process (for example, the Belgian luxury tax and the Italian petroleum products tax). The economic consequences of each country's using a somewhat different tax system, the relatively heavy reliance on indirect taxes in the Community, and the political difficulty of harmonizing direct taxes led EC countries in the early 1960s to focus on harmonizing their indirect tax systems.

Cascading Problems

4. Cascade tax systems have several characteristics that cause distortions in both domestic and international competition. A cascade tax is levied on the selling price each time a product is sold. Because the selling price at any stage of production or distribution includes cascade tax paid on previous transfers, the total tax on a product is affected by the number of times it changes hands on its way to the final consumer. Goods produced by a vertically integrated firm are taxed less than identical goods passing from firm to firm in the production process. Hence, the cascade tax discriminates in favor of industrial concentration.

5. The cascade tax can also directly distort the international competitiveness of a good because it is not possible to identify the exact amount of tax included in the price of a good produced for export or to compete with imports in the home market. Consequently, the size of export rebates and compensatory duties on imports (the so-called "border tax adjustments") cannot be determined precisely. A country may subsidize (or penalize) exports by rebating more (or less) tax than was actually paid. It may also – wittingly or unwittingly – penalize (or subsidize) foreign goods by applying compensatory duties greater (or smaller) than the taxes being paid on equivalent domestically produced goods. To mitigate such distortions, the Rome Treaty provided for "average compensation percentages" to determine rebate and compensatory duty levels on

equivalent products exchanged within the EC. However, these percentages were often too high (Italy) or too low (West Germany), and they remained a source of dispute among EC countries. This situation highlighted the need for a common system to calculate the exact amount of indirect tax levied on a particular product.

6. An additional consideration favoring change was recognition that a cascade tax produces double taxation. Because cascade taxes previously paid cannot be identified in the selling price at each step in the production-distribution process, there is no simple way to calculate and rebate the cumulated taxes paid on goods and services -- for example, investment goods, primary and auxiliary materials, and transportation -- used in production. Cascade tax paid on investment goods becomes part of the book value of an asset and results in higher depreciation charges, thereby increasing total costs. This element of cost, to the extent that it is embodied in the selling price, is subjected to tax levies as a good moves through subsequent production-distribution stages. Thus a product's price to the final consumer tends to be inflated by the "tax on tax" attributable to greater use of capital. This aspect of the cascade tax may also affect the competitive position of firms producing export goods if the tax rates applicable to overhead expenditures are different at home and abroad. Compared with a VAT that exempts investment transactions, the cascade tax favors the labor-intensive over the capital-intensive firm.

EC Adoption of VAT

7. The EC sought an indirect tax system that would affect competition minimally, guarantee relatively high tax yields, minimize administrative difficulties, reduce tax evasion, permit exact border tax adjustments, and facilitate the future elimination of tax frontiers within the Community. A basis for this was provided in the Rome Treaty. Article 99 states that "the Commission shall consider in what way the laws of the various Member States concerning turnover taxes, excise duties, and other forms of indirect taxation, including compensatory measures applying to exchange between Member States, can be harmonized in the interest of the Common Market." It was recognized, however, that harmonization of indirect taxes requires substantial changing of member countries' tax laws, and no timetable was spelled out in the Treaty.

8. Distortions of economic flows among EC countries arising from different indirect tax systems could be eliminated only by adopting a system having two important characteristics. First, the tax burden on equivalent products made by different enterprises should be the same, irrespective of the number of changes in ownership as a good passes through various stages of production and distribution. This characteristic is known as neutrality. A neutral tax would eliminate the tax advantages to vertical integration

inherent in the cascade tax. Second, the tax burden at each production-distribution stage should be exactly calculable. This latter characteristic -- called **transparency** -- is necessary for equitable treatment of a good crossing the border between two countries. With transparency a good can be freed of indirect taxes imposed by the exporting country (by rebating the exact amount paid) and subjected to a levy in the importing country exactly equal to indirect taxes paid on equivalent, domestically produced goods.

9. After lengthy consideration the EC Council decided to adopt a pure, consumption type of VAT that exempts exports and investment goods. Levied only on value added at each production-distribution stage, such a tax would be both neutral and transparent. This form of VAT is equivalent in effect to a single-stage retail sales tax.(1) In April 1967 the Council directed member countries to implement VAT by January 1970. This move was envisioned as the first phase of indirect tax harmonization. A second phase, as yet with no target date, would harmonize rates and exemptions to lay the foundation for removing indirect tax frontiers among EC countries.

10. All EC countries except Italy have implemented VAT. Italy was scheduled to do so in July 1972 but now plans to delay action until January 1973 because of domestic economic and political pressures. The EC Council made retail distribution coverage optional because administrative costs were expected to be excessive in relation to anticipated revenues. Nevertheless, all EC countries decided to include retail distribution, because tax evasion -- a major problem in Europe -- can be minimized by covering all production-distribution stages under a single, integrated indirect tax system. France moved first, extending its VAT to wholesale and retail distribution and other services effective January 1968. Subsequently, West Germany, the Netherlands, Luxembourg, and Belgium converted to VAT. In switching to VAT, the EC countries have had to eliminate many traditional levies on services as well as some local-option sales taxes.

11. Present VAT rate structures in the EC vary widely, reflecting each member country's desire to maintain tax yields at levels approximating those of the taxes VAT was replacing.(2) In terms of effective rates (based on selling price before tax is added), for example, the general VAT rate varies from a low of 10% in Luxembourg to a high of 23.46% in France (see Table 1). In addition, each country has one to three alternative rates

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1. A simplified example, illustrating the mechanics of the VAT and its equivalence to a retail sales tax, is included as Appendix A.
2. Rates and coverage and scope of VAT characteristics for each EC country are summarized in Appendix B.

Table 1

European Community:
Value-Added Tax Rates

Percent

Country	General Rate	Reduced Rates		Increased Rates
		Low	Medium	
Belgium	18.00	6.00	14.00	25.00
France	23.46	7.53	17.65	33.33
Italy a/	12.00	6.00	--	18.00
Luxembourg	10.00	5.00	--	--
Netherlands	14.00	4.00	--	--
West Germany	11.00	5.50	--	--

a. Probable rates to be introduced in 1973.

applying to specified transactions. In all EC countries, it is established social policy to tax necessities – such as foodstuffs, utilities, and public transportation – at half or less of the general rate. Also, France and Belgium have – and Italy is expected to have – special, increased rates for luxury goods such as automobiles, jewelry, perfumes, and alcoholic beverages.

12. The EC countries accord exemption from VAT universally to investment goods. Also commonly exempted are: small-scale farming and small-scale business that individually generate minimal tax revenue; medical, cultural, and other services receiving government subsidies; and internationally traded goods and services taxed by other countries, such as exports, international shipping, and processing for foreign customers. Two basic administrative procedures are used in handling exemptions. The most common is outright exclusion from the VAT system. Excluded firms may, however, opt to be included in the VAT scheme, the advantage being that they can then deduct VAT paid on business overhead expenditures. A second procedure, the "zero-tariff," is now used in the Netherlands and Luxembourg. Other countries may adopt this procedure because of its administrative efficiency. Certain goods and services are assigned a zero tax rate so that no VAT is payable on their sales, but VAT paid on purchases of materials and other inputs can be recovered by the firm. This procedure has the administrative advantage of including exempted goods under a systematic invoicing procedure applicable to all product classifications. Although the invoicing procedures vary among EC countries, all insure that tax at each stage is stated separately, a feature that allows the compounding of taxation to be avoided.

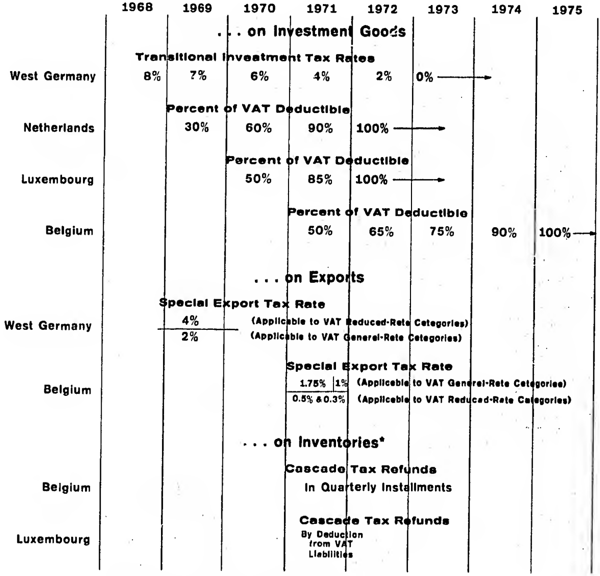
13. To mitigate the anticipated economic impact and administrative disruption attendant on changeover to VAT, the EC Council permitted member countries to implement gradually exemptions that apply to exports, investment goods, and inventory adjustments (see Figure 1). If these transactions initially had been exempt from VAT, many businesses – prior to the changeover – would have postponed investment, delayed export production, and decreased inventories of goods until the cascade tax was replaced by VAT. The transitional measures now have ended in France, the Netherlands, and Luxembourg. West Germany's special investment tax will be removed at the end of 1972. In Belgium, export transactions were completely exempted in January 1972, but investment transactions will not receive full exemption until the end of 1974. Some fiscal distortion of intra-EC trade and competitiveness will continue until transitional measures are ended and VAT is in effect throughout the Community with full coverage and exemptions. This distortion arises because the taxes applied to exports and investment during the transition period are not subject to border tax adjustment.

VAT Proliferates

14. Reacting to the EC's choice of VAT as a common indirect tax, Denmark, Norway, and Sweden have implemented VAT. Ireland is scheduled to follow in March 1972 and the United Kingdom in January 1973. These countries' close trading relations with the EC, combined with the desire of the United Kingdom, Denmark, Norway, and Ireland for EC membership, were powerful factors behind their adopting VAT. It is likely that other West European countries will soon move toward adopting VAT. Accession to EC membership by the United Kingdom, Norway, Denmark, and Ireland in 1973 will increase the pressure on the remaining European Free Trade Association (EFTA) members – Austria, Finland, Iceland, Portugal, and Switzerland – to adopt VAT because more than half of their trade is with the EC Ten. Austria, because of its close trading relationship with West Germany, is actively considering VAT. Turkey sees VAT as partly replacing its corporate income tax, which is often evaded by small producers and merchants. Adopting VAT would facilitate border tax adjustments on a major portion of their foreign trade, reduce tax evasion, and generate high revenue yields.

15. London plans to introduce VAT in 1973. The VAT will replace the Purchase Tax (PT) and the Selective Employment Tax (SET) and add retail trade and services to the tax base. Although the SET is paid by all manufacturing establishments, so-called "development" industries receive SET refunds plus a premium. The PT is applied at the wholesale level with a different rate on each of four specified groups of goods. No VAT rate structure has been proposed by the government, but the general rate probably will be between 10% and 20%, falling within the present range

Transitional Measures . . . **Figure 1**



**To avoid double taxation of goods-in-stock on which cascade taxes had been paid at time of introduction to VAT.*

513352 3-72

among the Six. A lower rate schedule would not yield full replacement of PT and SET revenues. Invoicing, tax collection, and other administrative procedures associated with the VAT probably will be similar to those now used in the EC.

16. In July 1967, Denmark became the first non-EC country to introduce a VAT system and the first country to extend VAT coverage to all goods and services through the retail stage. Foodstuffs, previously exempt from the selective wholesale sales tax, were included. Until July 1970 the VAT was levied at each production-distribution stage at a general rate of 12.5% on domestic goods and services and at a reduced rate of 9% on imports by registered traders. In July 1970 the general rate was increased to 15%, as was the import rate. Lower-bracket income tax rates were reduced and child welfare allowances were increased to compensate for the higher VAT rate. Exempt from VAT are exports, international shipping, aircraft and ships, newspapers and books, intangible property, and bonds and shares.

17. Sweden replaced its single-stage retail sales tax with VAT in January 1969. The general rate is 17.7%. Reduced rates of 9.9% and 3.1% apply respectively to property, hotel, and restaurant services and to road construction, other construction, and architect's services. The purchase of capital equipment is taxed at a preferential 6% rate. Exempted are exports, fishing boats and other small craft, civil aircraft, medicines, fuels, newspapers, certain publications, and works of art. Unlike other countries, Sweden includes agricultural activities under VAT.

18. Norway introduced VAT in January 1970, replacing a retail sales tax that applied only to domestically produced goods. The single rate of 20% covers all goods and services, including imports through the retail stage, but excluding capital equipment. Capital equipment, however, is subject to an 11% investment tax. Exports, aircraft and ships, certain fuels, utilities, newspapers, and specified agricultural products are exempt from VAT.

19. Ireland will introduce VAT in March 1972, and few transitional difficulties are expected. Ireland planned to implement VAT in January 1972 but delayed because businesses had insufficient time to prepare for the changeover after the necessary legislation passed in late 1971. The proposed rates, 5.26%, 16.37%, and 30.26%, are expected to yield budget revenues approximating those of the retail turnover tax and the two-tier wholesale tax being replaced. Fishing and agricultural activities will be exempt.

VAT's Price Effects

20. During the changeover to VAT, each EC and Scandinavian country has used a reduced rate schedule to minimize price inflation resulting from introducing the new tax system. However, sellers' reactions to the rate changes have produced a "ratchet" impact on prices. In most cases, tax increases are passed on in higher prices, but price decreases – even if justified by reduced taxes – are resisted. Typically, there has been an initial spurt in the general price level, followed by a year or two of more rapid increase than before the switch to VAT. In addition to its domestic economic consequences, of course, this additional inflation tends to erode somewhat the competitive advantage accruing from the use of border tax adjustments.

21. Denmark, Norway, and the Netherlands probably had the worst experience with VAT-associated price rises aggravating existing inflation. Denmark introduced VAT in July 1967. The Danish Government estimated that more than half the 7.6% increase in consumer prices (excluding rent) reflected the ratchet impact following VAT implementation. In 1968 the overall increase was 7.7%, of which an estimated 2% was due to raising the general VAT rate from the transitional 10% to the schedular 12.5%. Consumer prices spurted again after July 1970, following an increase in the general VAT rate to 15%. In 1969, prior to VAT, Norway's consumer prices rose 3.1%. In the first three months following the introduction of VAT in January 1970, consumer prices soared 6.4%, of which an estimated 5.8% was attributed to the ratchet impact. The rise in consumer prices for the full year 1970 was 10.6%.

22. In 1968, prior to VAT, consumer prices in the Netherlands increased 3.7%. With implementation of VAT, consumer prices jumped 7.5% in 1969. The Dutch Government estimated that approximately one-fifth of the rise was attributed to VAT. Also exerting strong upward pressure on prices were increased stockbuilding (with a very large import content), strong export demand, accelerating wage costs, and an ineffective price control program. Nevertheless, the Dutch Government believed that the extent of the price rise was due in large measure to anticipatory buying triggering a price spiral. The government estimated that VAT was responsible for 4.5% out of the 11% overall rise in residential construction prices, and 4.0% out of the 10.5% overall rise in public construction prices. Anticipatory buying occurred again in late 1970, and sales of durable goods were very sluggish for several months following the increase in VAT rates to their full levels in January 1971.

23. West Germany, France, Sweden, Belgium, and Luxembourg had little VAT-associated inflation. When West Germany introduced VAT in 1968, pressure on domestic prices was minimal. Unused capacity was

sufficient to moderate inflationary effects. The West German Government found that only one-third of the 1.5% increase in the overall cost of living in 1968 was attributed to VAT. Furthermore, because border tax rebates on West German exports had been set too low under the cascade tax system, export prices declined by 1.3% in 1968 when the higher rebates went into effect under VAT. These adjustments, combined with higher compensatory levies on imports, gave West German goods a competitive edge equivalent to a 2% devaluation of the Deutschemark, according to Federal Reserve estimates. France had little inflationary problem from extending its VAT to cover retail transactions because the rates adopted and the revenue yielded were comparable with those of the special retail taxes VAT replaced. Sweden escaped inflationary consequences when it replaced its retail sales tax by a VAT with identical rates, coverage, and revenue yield.

24. Belgium postponed introducing VAT because inflationary pressures were strong in January 1970, the original target date. This calculated gamble appears to have worked: when VAT was introduced in January 1971, overall price pressure in the economy was relatively slack. The consumer price index for all goods and services rose only 3.8% during 1971, significantly less than expected. Partly responsible, however, was a governmentally administered price freeze designed to offset the anticipated inflationary ratchet. Luxembourg, in contrast to Belgium, proceeded to introduce VAT in 1970 during a period of strong price pressure. Nevertheless, the Luxembourg Government estimates that VAT was responsible for only 1% out of that year's 4.6% rise in the cost of living index. This result undoubtedly stemmed from the gradual introduction of VAT, use of rates lower than those imposed in other countries, a slight reduction of the overall tax burden, and close control of prices.

25. After long delay, Italy's VAT legislation was approved as part of the comprehensive tax reform passed in October 1971. Incomplete administrative preparations, fear of inflationary consequences, and the current political turmoil have led to the decision to postpone VAT's implementation until January 1973. Because of the delay, inflationary pressure in the Italian economy is likely to be somewhat stronger at the time of VAT's introduction than had been anticipated. A recent Italian Government study concludes that the overall direct and secondary effects of VAT will cause a 2% to 3% rise in consumer prices, with a 1% rise occurring immediately following VAT's introduction. Price decreases are anticipated for electric power, rents, some processed foods, and radio and television appliances.

26. Beyond their immediate and direct inflationary effects, price changes triggered by the introduction of VAT lead to shifts in resource use and in the composition of final demand. Switching from the cascade tax to VAT provides a stimulus to investment by exempting investment

goods from tax, thus lowering their cost. Whereas the cascade tax artificially promoted labor-intensive industrial organization by taxing investment, VAT exempts investment transactions and is neutral between capital-intensive and labor-intensive productive processes. Where introduction of VAT results in changing the relative price between consumer goods, or between consumer goods and investment goods, the economy's output mix will be affected. In switching to VAT, EC countries applied transitional measures to investment transactions to prevent revenue shortfalls that would have resulted from immediate, complete exemption of investment goods. Without such measures, higher VAT rates on consumer goods would have been needed, intensifying the inflationary impact of VAT. Also, transitional measures served to forestall an abrupt, disruptive shift toward investment purchases following VAT's introduction.

Implications for the United States

Impact of the West European VAT

27. The West European countries' widespread use of VAT – employing border tax adjustments and exempting investment goods – gives their products a distinct competitive advantage in international commerce. Future moves toward harmonizing VAT rates in the EC will intensify this advantage at a time when export expansion will be increasingly urgent for the United States. The VAT countries' competitive edge over the United States stems from their heavy reliance on indirect taxation and from the General Agreement on Tariffs and Trade (GATT) rules that permit indirect – but not direct – taxes to be rebated on exports and levied on imports. In Western Europe, indirect taxes (for example, cascade, value added, and excise taxes) generally provide one-half or more of total revenues, while in the United States direct taxes (for example, corporate income, personal income, and property taxes) account for nearly two-thirds (see Table 2). Because the "indirect tax content" of selling price is high in the West European countries and relatively low in the United States, border tax adjustments – by eliminating indirect taxes from export prices and adding them to import prices – tend to give West European goods a competitive advantage over US goods. The extent of this advantage, however, depends on the relative impact of direct and indirect taxes on prices and profits – a matter on which economists differ widely.

28. The GATT provision allowing border tax adjustments for indirect taxes is based on the assumption that such taxes are completely passed along to the consumer and, thus, are an element in the final price of a good. Border tax adjustments on direct taxes are not allowed, because of the questionable assumption that direct taxes do not increase the final price of a good but rather decrease the remuneration of factors used in its manufacture. There is little evidence, however, to suggest that indirect taxes

Table 2

Relative Importance of Direct and Indirect Taxes in Western Europe and the United States 1969

	Percent of Total Taxes a/	
	Direct Taxes	Indirect Taxes
United States	63	37
The "Six"		
Belgium	45	55
France	30	70
Luxembourg b/	49	51
Italy	35	65
Netherlands	57	43
West Germany	42	58
EC Entrants		
Denmark	43	57
Ireland	40	60
Norway	49	51
United Kingdom	47	53

a. "Total taxes" here include revenues at all levels of government but exclude contributions for social security. Direct taxes are revenues from household and corporate income taxes. Indirect taxes are revenues from sales and excise taxes.
b. 1968.

are fully passed along to the consumer, or that direct taxes are fully realized in a decrease in factor income.

29. An additional competitive concern is the exemption of investment and other business overhead from taxation under the EC's consumption type of VAT. In contrast, a direct tax system such as that used in the United States burdens investment and business overhead outlays at the source without allowing for subsequent deduction of the tax. This disadvantage is accentuated by the fact that in Western Europe, although corporation income tax rates are nominally similar to those in the United

States, exclusions from the tax base are more generous and tend to lower the direct tax burden on West European producers. For example, tax deductions are allowed for additions to reserves, and earnings paid out as dividends are subject to reduced rates. Because there is no provision under GATT for the removal of differential treatment of direct and indirect taxes, VAT's treatment of investment, in effect, gives West European manufacturers an additional competitive advantage relative to US manufacturers. The tax incentives of the new Domestic International Sales Corporations (DISCs) offer US firms a means of eliminating some degree of competitive disadvantage arising from international differences in tax systems.

30. The West European countries' switch to VAT from cascade taxes or single-stage retail taxes has had little immediate impact on US trade. Where VAT has replaced cascade taxes, the main effect of VAT's introduction has been the more accurate calculation of export tax rebates and compensatory levies on imports. In the case of West Germany, the slight "devaluation" effect resulting from introduction of VAT was soon offset by the 1969 French devaluation and West German revaluation, as well as by some inflationary ratchet effect of VAT on domestic prices. In the Scandinavian countries, the competitive position of internationally traded goods was essentially unaffected by the substitution of VAT for single-stage retail taxes.

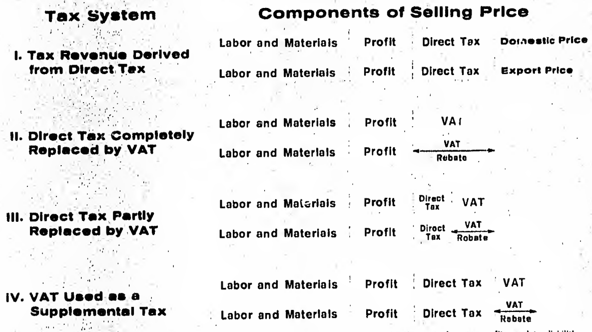
31. Although the immediate impact of VAT's introduction in Western Europe has been slight, EC progress toward economic integration in the 1970s will make taxation differences affecting international competitiveness increasingly important. Rate harmonization will increase the share of the EC countries' total tax revenue provided by indirect taxes and thus -- through border tax adjustments -- heighten the competitiveness of their goods. For most of these countries, VAT rates will be increased and direct tax rates decreased somewhat. For example, West Germany would raise its 11% general VAT rate to an envisioned EC norm of 15% and, consequently, cut direct tax rates to keep revenues at the desired level. The impact of VAT's exemption of investment goods to date has been mitigated by the transitional measures employed. As these measures are phased out in the mid-1970s, however, VAT's competitive challenge to the United States will increase.

A US VAT

32. The adoption of VAT by the United States as a new source of Federal government revenues could make US goods more competitive in world markets -- if VAT revenues should supplant to some degree revenues now derived from direct taxes such as the Federal corporation income tax. This is because exports would then qualify for substantial tax rebates under

the GATT rule, and border tax adjustment for indirect taxes would reduce export prices. This effect is illustrated in Figure 2. For purposes of illustration, it is assumed in each case that labor and material costs are the same. However, because direct taxes are generally believed to reduce the remuneration of factors of production, the partial or complete replacement of direct taxes by VAT probably would result in an increase in costs of production. This effect would moderate the gain in competitiveness of US exports.

VAT "Rebate Effects" on Export Price **Figure 2**



Note: Lengths of segments are not proportional to actual costs, profits, and tax liabilities.

513353 3-72

33. When tax revenue is derived exclusively from a direct tax (Tax System I), the domestic selling price and the export price are the same – no tax relief is afforded exports. When VAT replaces the direct tax completely or partly (II and III), exports can be relieved of indirect tax burden through rebating, and the export price can be reduced. In the case of a VAT supplementing existing direct corporation tax revenues (IV), there will be a tendency for domestic prices to rise while export prices remain unchanged. In this situation, because of the rebate feature, VAT need not affect export price.

34. The precise outcome, of course, depends on several factors. For example, in the case where VAT supplants the corporation income tax to some degree, producers and sellers might resist passing on to consumers the benefits of lowered corporation income tax rates. The result would be some increase in prices to buyers, reflecting an augmentation of the seller's after-tax profit (the ratchet impact noted above in connection with the inflationary impact of VAT). Furthermore, consumer reaction would have to be taken into account. Higher domestic prices resulting from ratchet impact or use of VAT as a supplementary tax would affect the quantities of various goods purchased. Longer run income effects would change underlying demand relationships and be especially burdensome to low-income recipients unless they were afforded some form of relief.

Outlook and Conclusions

35. The spreading use of VAT eliminates many fiscal distortions of economic relationships inherent in older indirect tax systems. Pioneered in the EC, VAT removes the cascade tax's incentive to vertical integration of industry and permits exact calculation of border tax adjustments. Rebates can free exports of domestic taxation, and compensatory levies can burden imports with taxes equivalent to those paid on domestic goods with minimal chance of such adjustments concealing subsidies or barriers to trade. Some fiscal distortion of trade continues, however, until transitional measures associated with the introduction of VAT are ended.

36. Inflationary pressures resulting from VAT's ratchet impact on prices have varied substantially, depending on the specific transitional measures employed by each country. The countries experiencing the worst inflationary consequences from introducing VAT were those having the greatest price pressures from other causes. Upon introducing VAT, West European countries have generally experienced a price spurt followed by a year or two of more rapid inflation than before.

37. Further harmonization of indirect taxation in the EC would require establishing norms for rates, exemptions, and administrative procedures. Given present differences in VAT rate structure among the member countries, it is clear that negotiation of such norms not only would entail jockeying for relative advantage but also would create internal problems. Sizable shifts in the incidence of taxation could produce unsettling changes in the balance of social, economic, and political forces in some countries. For example, France would have to lower its high VAT rates substantially to conform with the EC norm of 15% presently envisioned by the Council. It then would be faced with raising some or all of its direct tax rates to offset the decrease in VAT revenues, a move

almost certain to be vigorously resisted by the influential wealthier classes. Other member countries would face related, if less drastic, problems from adjusting their indirect rates to conform with an EC norm.

38. The EC's central organizations will probably press for Community-wide alignment of VAT rates and adoption of the "country of origin" principle to permit the ultimate elimination of border tax adjustments. In effect, each good would be taxed only in the producing country, eliminating the necessity for border tax adjustments. Extra-EC trade would, of course, still be subject to border tax adjustments.

39. The biggest obstacle to further indirect tax harmonization in the EC is the attendant impairment of fiscal sovereignty. Once VAT rates and exemptions are aligned with Community norms, individual member countries no longer will be allowed to change them freely as a discretionary tool of fiscal policy. Community members clearly will have to demonstrate greater willingness to relinquish certain aspects of national fiscal autonomy if the degree of indirect tax harmonization consonant with the EC's goals of enhanced industrial growth and economic union is to be realized. The four entrant countries most likely will have adopted the VAT by the probable date of actual entry, 1973, but their accession may add to the complexity of harmonization negotiations and delay progress toward alignment. It is not expected that rate alignment can be effected before the late 1970s.

40. The competitive challenge of Western Europe's VAT will be a vexing problem as the United States seeks to expand its exports in the 1970s. In the circumstance, increased attention will probably be given to finding means for offsetting taxation differences affecting international trade. One such difference stems from the United States' heavy reliance on direct taxation to generate government revenue. The GATT articles dealing with border tax adjustments do not sanction adjustments for direct taxes but do permit rebate of indirect taxes. With a large share of their tax revenues coming from indirect taxes such as VAT (and, formerly, the cascade taxes), West European countries are able to enhance significantly the international competitiveness of their products by rebating taxes on exports. US competitiveness could be enhanced if the United States were to adopt a VAT system supplanting a significant portion of the US corporate income tax. One result would be lowering of export prices by use of border tax adjustments.

41. Western Europe's use of VAT also tends to impair US competitiveness by allowing West European producers liberal indirect tax deductions to promote investment. The tax disadvantages to US trade are compounded by the fact that in Western Europe, although corporation income tax rates are nominally similar to those in the United States,

exclusions from the tax base are more generous. The impact on trade of these differences in the US and West European tax systems is, of course, offset to some extent by export and investment incentives inherent in US tax schemes such as the new DISCs.

APPENDIX A

Hypothetical Examples of Tax Calculations: VAT and Single-Stage Retail

A simplified example (see the accompanying table) illustrates VAT invoicing procedures under alternative rate structures and compares the results with the use of a single-stage retail tax. It is assumed that production and distribution of steel filing cabinets involves three stages of production. Company I purchases iron ore and sells steel. Company II purchases steel and sells filing cabinets. Company III, a retailer, purchases the filing cabinets and sells them to the consumer. The example is calculated so as to yield the same amount of tax revenue to the state under each alternative shown.

The alternative VAT rate structures illustrated are: (a) a constant VAT rate through all production-distribution stages and (b) a "progressive" VAT rate structure, applying higher rates of tax as the product moves through the stages of production toward final consumption. At each stage the net tax liability is computed by deducting the tax paid on purchases from that levied on the net value of goods sold. Thus, in Case A, Company II purchases steel from Company I, paying Company I a total of 165.00 – 150.00 for the steel and 15.00 (10% of 150.00) for the tax paid to the state by Company I but recovered from Company II. When Company II produces filing cabinets, it adds 72.00 to the value of the product, bringing the net value at time of sale to Company III to 222.00. Company II invoices the sale at a total of 244.20, the net value (222.00) plus the accumulated tax liability charge (10% of 222.00) to be passed on to Company III. The amount that Company II pays to the government as net tax liability is 7.20 (22.20 - 15.00). The mechanics of the deduction scheme used to pass the tax liability forward to the final consumer – the so-called "indirect subtraction method" – are similar for each stage in Cases A and B. In Case B, however, the VAT rate structure is progressive. Under the single-point retail tax (Case C), a tax – in this example, 10% – is applied only on the sale by Company III to the final consumer.

VAT is applied only on value-added at each stage, and the single-point retail tax is applied only on the final sale – equivalent to the sum of value-added through all stages of production and distribution. Both taxes are non-distortive because neither tax is applied to a previously taxed base. Also, because the rates at the final stage in this example are the same, the tax revenue is identical. Under the progressive VAT rate structure (Case B), the tax revenue is the same as that from the constant VAT structure and the single-point retail tax because the rate at the final stage generally dominates. This is the consequence of the deduction scheme used

with the VAT. If the rate structure were "regressive" with a lower rate at the end, then it is possible that a net tax credit rather than a net tax liability would accrue at the final stage. This, of course, would depend on the difference between the high rate and the low rate and on the size of value-added at the stage in question.

Hypothetical Examples of Tax Calculations:
VAT and Single-Point Retail

	Net Value	VAT Rate (Percent)	VAT Levy	Invoiced Total
Case A: Constant VAT Rate				
Company I				
Purchases: ore	100.00	10	10.00	110.00
Value added	50.00			
Sales: steel	150.00	10	15.00	165.00
Net tax liability to company I: 15.00 - 10.00 = 5.00				
Company II				
Purchases: steel	150.00	10	15.00	165.00
Value added	72.00			
Sales: filing cabinets	222.00	10	22.20	244.20
Net tax liability to company II: 22.20 - 15.00 = 7.20				
Company III				
Purchases: filing cabinets	222.00	10	22.20	244.20
Value added	50.00			
Sales: filing cabinets	272.00	10	27.20	299.20
Net tax liability to company III: 27.20 - 22.20 = 5.00				
Case B: Variable VAT Rate				
Company I				
Purchases: ore	100.00	5	5.00	105.00
Value added	50.00			
Sales: steel	150.00	7	10.50	160.50
Net tax liability to company I: 10.50 - 5.00 = 5.50				
Company II				
Purchases: steel	150.00	7	10.50	160.50
Value added	72.00			
Sales: filing cabinets	222.00	7	15.54	237.54
Net tax liability to company II: 15.54 - 10.50 = 5.04				
Company III				
Purchases: filing cabinets	222.00	7	15.54	237.54
Value added	50.00			
Sales: filing cabinets	272.00	10	27.20	299.20
Net tax liability to company III: 27.20 - 15.54 = 11.66				
Case C: Single-Point Retail Tax				
Company III				
Sales: filing cabinets	272.00	10	27.20	299.20
Net tax liability to company III: 27.20 - 0.00 = 27.20				

Summary

	Net Tax Liability at Each Stage of Production								
	Seller of Ore	+	Co. I	+	Co. II	+	Co. III	=	Total Tax Paid
Constant VAT rate levy	10.00		5.00		7.20		5.00		27.20
Variable VAT rate levy	5.00		5.50		5.04		11.66		27.20
Single-point retail tax	N.A.		N.A.		N.A.		27.20		27.20

APPENDIX B

Summary of Value-Added Tax Provisions in Eu

	France	West Germany	Netherlands
Effective date	1968 [2]	1968	1969
Scope	All goods and services through retail, and imports.	All goods and services through retail, and imports.	All goods and services through ret imports.
Rates and coverage:			
Low	**7.53%** Dairy products, basic foodstuffs, raw agricultural produce, certain cultural, accommodation, and social services, and scientific books.	**5.50%** Live animals, food supplies and related agricultural products, certain professional services, books, newspapers and other like products, and invalid and medical appliances.	**4.00%** Basic foodstuffs, certain agricultura ucts, gas, electricity, coal, mine public transport, and accommod
Medium	**17.65%** Wines, household soap, gas, electricity, compressed air, steam, cars, passenger transport, and certain foodstuffs and accommodations not subject to the lowest rate.	Not Applicable	Not Applicable
Normal	**23.46%** All goods and services not specified elsewhere.	**11.00%** All goods and services not specified elsewhere.	**14.00%** All goods and services not specifi where.
Increased	**33.33%** Radios, television sets, new automobiles, tobacco, sound equipment, cinema and photographic equipment, precious stones, and luxury furs.	Not Applicable	In addition to VAT, passenger auto are subject to a 15% excise tax not deductible from VAT liabilit
Exemptions and "Zero Tariff"	Exempted: Investment goods, exports, banking, monetary or financial activities, and retailers and other small businesses whose VAT liability is less than $156 per year.	Exempted: Investment goods, exports to and processing for foreign customers, banking and financial transactions, lease and hire of buildings and dwellings, and educational, welfare, and medical services.	Exempted: Investment goods, tran structures built prior to January leasing of real property, medical s and supplies, cultural and social s certain insurance, and educational tic, and journalistic services. Zero tariff: Export deliveries and ass services, ocean-going vessels, intern passenger transport and service other services applicable to intern trade.
Method of payment	End of month or quarter; VAT due on sales less VAT paid on fixed assets and goods purchased. If VAT deductible exceeds VAT on sales, credit is carried forward.	End of month (quarter if liability in the preceding year was less than $372); VAT due on sales less VAT paid on purchases.	VAT remitted monthly by large prises, quarterly by small ones.

[1] The provisions shown are permanent features of the respective VAT systems. During the periods of changeover to VAT, transitional arrangem using transitional measures. Both countries continue to apply special measures to investment transactions (see paragraph 13 and Figure 1 of text).

[2] France has had a VAT system since 1954. The effective date shown is the year France conformed to the Council directives on indirect tax harmoniz

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APPENDIX B

Value-Added Tax Provisions in European Community Countries [1]

	Netherlands	Luxembourg	Belgium	Italy
	1969	1970	1971	January 1973
etail,	All goods and services through retail, and imports.	All goods and services through retail, and imports.	All goods and services through retail, and imports.	All goods and services through retail, and imports.
lated ofes- pers valid	**4.00%** Basic foodstuffs, certain agricultural products, gas, electricity, coal, mineral oils, public transport, and accommodations.	**5.00%** Foodstuffs, agricultural products, solid and liquid fuels, newspapers, periodicals, and public transport.	**6.00%** Animals for slaughter, food and drink (not spirits), grains, fruits, water, pharmaceuticals, orthopedic goods, newspapers, certain minerals, agricultural services, cleaning, hotels, and restaurants.	**6.00%** Basic foodstuffs, agricultural and fishery products, utilities, pharmaceuticals, soap, books, newspapers, nonluxury hotels, scientific equipment, admission tickets, and home telephone bills.
	Not Applicable	Not Applicable	**14.00%** Manufactured tobacco, coals and coke, electricity, petroleum and oils, buildings, shoes, some textiles, cinemas, travel agencies, parking lots, and telecommunications.	Not Applicable
ified	**14.00%** All goods and services not specified elsewhere.	**10.00%** All goods and services not specified elsewhere.	**18.00%** All goods and services not specified elsewhere.	**12.00%** All goods and services not specified elsewhere.
	In addition to VAT, passenger automobiles are subject to a 15% excise tax that is not deductible from VAT liability.	Not Applicable	**25.00%** Cars and motorcycles, planes and helicopters, yachts, other pleasure craft, jewelry, watches, furs, guns, television sets, records, perfumes, photographic equipment, and alcohol.	**18.00%** Jewelry, leather goods, art objects, cameras, sound reproduction equipment, carpets, cosmetics, autos larger than 1,600 cc., motorcycles larger than 250 cc., tobacco products, alcoholic beverages, fancy chocolates, luxury hotels, and barber and beauty services.
ports cus- rans- dings wel-	Exempted: Investment goods, transfers of structures built prior to January 1969, leasing of real property, medical services and supplies, cultural and social services, certain insurance, and educational, artistic, and journalistic services. Zero tariff: Export deliveries and associated services, ocean-going vessels, international passenger transport and services, and other services applicable to international trade.	Zero tariff: Investment goods, goods and services for export, transit traffic, public transport entering and leaving country, post office services, banks, insurance, rent on estates, medical services, domestic help, and cultural and sport organizations.	Exempted: Investment goods, exports, legal and medical services, financial services rendered by banks, and educational services.	Exempted: Exports and small businesses with sales of less than $8,600 per year.
n the 372); d on	VAT remitted monthly by large enterprises, quarterly by small ones.	Periodic collection..................	VAT payable monthly. Currently, estimated tax liability is due one month in advance.	VAT payable monthly. Simplified accounting procedures for firms with sales of less than $138,000 per year.

hangeover to VAT, transitional arrangements affecting exports and investment goods have been used. Belgium and West Germany are the only EC countries currently
paragraph 13 and Figure 1 of text).
Council directives on indirect tax harmonization.